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## Finance Company Systems

BY MORGAN A. CASEY

There appeared in THE JOURNAL OF ACCOUNTANCY for August, 1931, an article by D. Paul Musselman in regard to accounting systems of finance companies, and it evoked considerable interest. The following comments presume to offer constructive, though critical, suggestions based upon experiences somewhat contrary to those of Mr. Musselman.

Mr. Musselman makes the statement that the process of trial and error which tends to establish standards in accounting systems has made little advance in the case of transactions peculiar to finance companies; and he states that while forms have been borrowed and adapted from other kinds of business, they have proved awkward and inefficient when tested by the special demands of the new type of enterprise. Such inadequacies may obtain as to finance companies in general, but it is certain that some of the older and larger companies have developed extremely efficient systems which do make readily available the information necessary for proper management and do facilitate a thorough audit.

### INSTALMENT-NOTE LEDGER

Mr. Musselman says that companies dealing in several types of notes may find it advisable to departmentalize them into several groups, each with its separate control and separate subsidiary ledger. This point is of importance. As the volume of business of any particular group increases, further sub-division should be made to prevent the individual subsidiary ledgers from becoming unwieldy in balancing detail with control records. This step of further subdivision is often deferred with a resultant loss of efficiency.

Mr. Musselman says the ledger should be designed for:

- A Facility in finding accounts for posting.
- B Facility in effecting agreement with the control.
- C Infallibility in revealing delinquents.
- D Facility in obtaining data relative to future cash position.

I concur in attaching paramount importance to the first three items enumerated, but some question arises with regard to item D, as to whether the managerial problem of determination of

future cash position is closely related to the requirements of the most efficient form of subsidiary ledger.

I find myself at variance with Mr. Musselman concerning the form of ledger which most nearly satisfies all requirements. A ledger of cards for individual accounts is proposed as more suitable than the Boston ledger described by Mr. Musselman, in which

“The individual accounts are set up horizontally, one account appearing below the other—the vertical columns (in pairs) representing periods of time, any period from a day to a month or more, depending upon how frequently reports are desired by the management.”

The form of the proposed ledger card may be varied to suit local conditions. An illustration of the general form is a card in which there appears in the upper margin the necessary identification of the account, including the serial number assigned to the note, the name and address of the maker and dealer, the date of purchase of the note and any other relevant information; the left side of the card will show the total amount of the paper, together with the amounts of each instalment entered (vertically) opposite the month when due; and the center and right side will have the names of the months listed vertically, with vertical columns also for debit, credit and balance, and adequate provision for references.

*Facility in finding accounts for posting.* Cards in trays or “tubs” mounted on movable standards permit the finding of individual accounts with less physical exertion than by the handling of bound book ledgers. The cards also have the advantage of greater visibility, since by the use of “tabs” the approximate location of the desired card may be determined by merely scanning the “tabs” without the opening of covers and turning of pages. Orderly arrangement likewise may be obtained in the card system with the same facility as in the Boston ledger, either alphabetically or under some other form of classification, with the decided advantage of ease of elimination of closed accounts from the current record when cards are closed. Mr. Musselman makes the statement: “Where card systems are in use the temptation to remove the accounts is practically irresistible.” I grant that on rare occasions a card may be removed from the file and mislaid, but this defect is practically negligible under competent office management.

Although Mr. Musselman’s point may be admitted that “actual posting is a simple operation in any system,” nevertheless the

mechanical operations of voluminous postings can not be completely ignored. Frequently, conditions are such that "machine" posting is more efficient than "longhand" posting, and, obviously, "machine" posting requires the use of cards or loose-leaf sheets.

*Facility in effecting agreement with the control.* It is granted that, after the completion of the footings of the current and future due columns and the carrying forward of the delinquent balances, the remaining step necessary in determining whether or not the Boston ledger is in agreement with the control is a relatively simple one. Its superiority over the card system appears to be only that it requires less time to complete than is required to draw off a trial balance of the cards in the regular way. It would seem, however, that neither system has any advantage as to localizing possible errors. It has been my experience that no particular difficulty is encountered in balancing card ledgers, provided that the office routine includes an inviolable rule that all ledgers be balanced during each month. In large organizations this may be facilitated by "staggering" the balancing throughout the month, i. e. drawing off detail trial balances of the various ledgers at different dates and reconciling such trial balances with month-end control balances.

Under the regular routine of the system proposed by Mr. Musselman, the amount of each individual balance is calculated only in the case of delinquent accounts. Mr. Musselman states that "No one wants to know the balance in the individual accounts ninety-nine per cent of the time. . . . Let the interim balances be computed in individual cases where necessary." As computations of individual balances necessitate additional work and are seldom called for, it is quite logical in the case of the Boston ledger that this be done only on delinquent accounts; but, where bookkeeping machines are used the calculation is mechanical, entailing little additional effort on the part of the operator. In the card system the individual balances are available whenever needed for credit purposes, determination of outstandings by dealers, etc., without any delay in computing them.

The functioning of the card system may be described briefly by considering the various types of entries commonly made, as enumerated by Mr. Musselman, viz.:

1. Instalment-note purchases.
2. Collections and charge-backs to dealers.

3. Dishonored cheques and protest fees.
4. Re-writes.
5. Repossessions.
6. Adjustment of bookkeeping errors.

*Instalment-note purchases.* After the purchase of the paper has been completed, the ledger card may be prepared in one of two ways, both of which have been found to be practical:

(a) A "master billing sheet" is typed on a machine equipped with "ditto" ribbon. From this "master sheet" all needed copies are run off on a "ditto" machine. These copies may include the ledger card, branch record, insurance notice, dealer's notice, purchaser's copy, etc.

(b) An alternative method is that of using "light weight" sets of forms prepared in advance with carbon paper inserted as required so that the forms may be typed in one operation on an ordinary typewriter.

Method (b) makes possible the immediate distribution of the various copies, while method (a), of course, necessitates the second step of the "run-off" on the "ditto" machine. When branch offices are maintained, a workable routine under method (a) is for the branch to type the "master sheet" on "ditto" ribbon and send the "master" to the main office where "ditto" machines are maintained for the preparation of the several copies. A delay may occur before the proper copies are returned to branches some distance from the home office. If this delay proves detrimental to efficiency the second method (b) is preferable, as the complete set is typed at the branch, where proper copies may be available immediately. The organization structure of a given company will determine the best method of preparing the billing sheets.

Under either method the amount of the original debit is the total amount to be collected, with the amounts of the instalments shown in memorandum form as previously described.

*Collections and "charge-backs" to dealers.* Little comment is considered necessary with regard to collections, as the posting operation is simply a matter of appropriately recording the cash received. In large companies posting media, consisting of individual slips of paper for recording collections as received, are used to advantage. The specific details naturally vary with the type of cash records employed. "Charge-backs" to dealers offer no particular problem, as the entry is merely a credit to notes

receivable and a charge against the dealer's account (the latter ordinarily reflecting a credit balance because of "hold-backs").

*Dishonored cheques and protest fees* may be disposed of with the simple statement that they are charged against the notes-receivable account and are posted in the debit column of the ledger card with appropriate symbols or abbreviations indicating the nature of the items.

*"Re-writes."* If the commodity financed is income-producing, such as industrial machinery, occasions may arise where the original contract may have been written over too short a period and an extension of time may be granted to the maker of the note; but such an extension appears to be seldom granted in respect of non-income producing commodities, such as automobiles of the pleasure class, with the single exception of commodities financed on the "wholesale" plan, i. e. advances to dealers on commodities purchased from manufacturers or distributors. This exception appears reasonable, when it is considered that the commodity securing the advance is still unused and its value unimpaired, save only by the passage of time. (Of course, if repeated renewals are granted the commodity may become obsolete and its value as security may be impaired.)

When such an extension or renewal is granted a new contract is drawn and new set-up made in the notes receivable, with suitable notations in the receivable records so that the extension is not lost sight of in credit problems and consideration of reserve requirements. Whenever renewals or extensions are made, such new paper should never be included in the new business volume, and its elimination must be carefully watched.

*Repossessions.* I agree with Mr. Musselman that repossessions should be regarded in the first instance as a change in the legal status of the account, rather than as an accounting transaction, and that a memorandum of the occurrence should be entered in the detail account without further entries until the disposition of the collateral. Of course, the management should be informed currently of the condition of such accounts. However, it must not be lost sight of that this procedure of allowing the "repossessed" accounts to remain in the regular notes receivable is only a labor-saving expedient in order to eliminate numerous entries to the detail ledgers. Whenever a balance-sheet is prepared, cognizance must be taken of the "repossessions" included in notes receivable. It may be most practical to omit any ad-

justment for monthly statements prepared for management use only, as the executives, aware of the condition, will not be misled; but any balance-sheet which may reach outsiders or stockholders should give effect to the segregation of repossessed commodities stated at no more than realizable depreciated values. The adjustment for balance-sheet purposes may be made to control accounts only and reversed at the beginning of the succeeding period, thus eliminating the numerous entries to detail records.

There appears to be no real objection to so segregating only accounts discounted with dealers "without recourse" and with dealers of questionable financial standing. If this procedure is followed, "repossessions" of accounts with good dealers, against whom the finance company may have recourse, will be included in the notes receivable in the balance-sheet. The extent of such a condition should be stated in a footnote or accompanying comments.

*Adjustment of bookkeeping errors.* No difficulty is encountered in this respect in the card system.

*Infallibility in revealing delinquents.* It is evident that after the delinquent accounts are carried forward in the Boston ledger, a list of such accounts may be transcribed therefrom more readily than from the card ledger, but the advantage does not seem to be material in view of other disadvantageous features of the Boston ledger. Considerable doubt arises in my mind as to the efficacy of a record which contains two columns for each month or period when an instalment falls due (i. e. possibly forty or more money columns) the postings in which are to be made in several different colored inks.

*Facility in obtaining data relating to future cash position.* Earlier in these comments the statement was made that I did not concur with Mr. Musselman in the opinion that the managerial problem of future cash position was very closely related to the requirements of the most efficient form of subsidiary ledger. The Boston ledger, of course, does make available the "spread" of the paper by maturities. This, however, is only part of the information necessary, as future cash outlay will fluctuate with the volume and other indeterminate factors, and it seems that predictions of future cash position are little better than good guesses as to what may happen. In some cases where bankers' acceptances or "gold notes" are issued as a method of borrowing, it may be necessary to "spread" the paper by maturities. This

is done in some organizations by use of a sorting machine; in some companies the information may be developed in a separate statistical record. It is beyond the scope of these comments to discuss further the various factors involved in attempting to predict future cash position, but, in any event, I am of the opinion that it is impracticable to maintain the detail ledger in a form which makes directly available the "spread" of maturities.

Before leaving the subject of the instalment-note ledger, it may be stated that the specific details of the card system are subject to almost infinite variation. The form of the ledger sheet suitable for indirect collection paper is materially different from that outlined, but a detailed description of such a ledger is omitted for the sake of brevity.

Finally, mention is made of a modification of the card system under which bookkeeping machines are not used for posting. The ledger cards or sheets are prepared with a column reflecting the predetermined balance after each collection (assuming that the payments are made in accordance with the terms of the contract) and as collections are made the posting includes the recording of the cash received and the striking out of the former predetermined balance. To cover those instances where payment is made for an amount other than the instalment required by contract, a "short" column is provided on the ledger sheet in which is recorded the difference between the predetermined and the actual balance. In drawing off the trial balance of such accounts the amounts in the "short" and regular balance columns are appropriately combined. It would seem that the system here briefly outlined would be more suitable under conditions where most of the collections are for the exact amount of the instalment per contract, and would be less suitable where the class of paper discounted is such that collections for irregular amounts are comparatively frequent.

#### INSTALMENT-NOTE REGISTER

It is granted that entries of notes purchased should be recorded chronologically, but I do not agree with Mr. Musselman that such entries should be divorced from the cash records. On the contrary, a very satisfactory form of record is one which combines the functions of a cash disbursement book and the instalment register as outlined by Mr. Musselman. Such a record



would have the columns which he describes as suitable for the note register. The principal columns follow:

1. Dr. Instalment notes receivable,
2. Cr. Dealer's equity,
3. Cr. Unearned finance charges,
4. Cr. Insurance payable on collateral,
5. Cr. Dealer's surcharge,
6. Cr. Due in settlement;

and, in addition, would include the customary reference and explanatory columns for cheque number, etc., as in the common form of cashbook. In this record the column "due in settlement" would be the cash column for the amount of cash disbursed. A particular bank account (or accounts) should be used only for purchases of paper, and the record described above would then constitute the cash disbursements book for such cash accounts as well as a complete record of paper purchased. (A separate bank account should be maintained for miscellaneous disbursements, salaries and other incidental expenses, which may be recorded in a separate cashbook of the type commonly used.) Paper will be purchased rarely by a finance company without an outlay of cash, but an additional column or two may be included in the record for handling these infrequent transactions. The posting from the principal columns of this record would be the same as that described by Mr. Musselman, with the single exception that the column in his system, "due in settlement," is posted, under the system proposed here, as a credit to cash for the disbursements made for purchase of paper.

Possible variations and modifications of the note register will not be discussed further, but the following comments are made in reference to Mr. Musselman's description of the principal functions of the record:

If a suspense or temporary clearing account is used, special care should be exercised to prevent this account from becoming a convenient catch-all for small differences and adjustments. My personal experience includes an examination of a set of books where such a clearance or suspense account was used, in which there had been allowed to accumulate over a period of years minor differences in foreign exchange collections, adjustments of service charges, etc. This, of course, was an extreme case but, none the less, illustrates an important point. The regular routine of the office should include a periodic analysis of the items comprising

the balance in the suspense account, and items not cleared from the account within a reasonable time should be investigated and proper disposition made of them.

I agree with Mr. Musselman that the holdback from dealers should be treated on the balance-sheet as a deduction from notes receivable rather than stated on the liability side. There is little defense for the latter procedure.

#### CASH RECORDS

I am in entire agreement with Mr. Musselman in the point made that petty cash, or funds in the hands of agents or branches, should be handled by the imprest system. As to the form of cashbook, however, a segregation of the records of receipts and disbursements is proposed rather than the combined record suggested by Mr. Musselman. Comments were made on the disbursements records in the discussion of the instalment-note register under which the proposed record serves as a cash-disbursements record for purchase of paper and as a note register. The record of receipts presents no unusual problems. Suffice it to say that the records should be such as to facilitate posting to the subsidiary notes receivable ledgers; to aid recapitulation by the same classification maintained in the departmentalizing of the notes receivable, and to facilitate bank reconciliations.

A routine of daily deposits of all receipts is a primary requisite of a system which adequately controls the handling of cash. It would appear from Mr. Musselman's pro forma "cashier's daily settlement" sheet that disbursements are made direct from receipts, since the form reflects cash expenditures and fund reimbursements as a deduction from cash on hand before determination of the amount to be deposited. Such a practice is strongly to be condemned. Receipts should be deposited intact and disbursements made by cheque, except for minor items from petty cash.

A daily statement of cash in banks should be prepared, the form of which may vary with the particular conditions existing. Such statements generally consist of a list of the banks, with the following information shown in more or less detail:

Balance at close of previous day.  
Withdrawals.  
Deposits.  
Closing balance.

DISTRIBUTION OF UNEARNED FINANCE CHARGES

Although the method of distribution of unearned finance charges proposed by Mr. Musselman has the advantage of simplicity, I am of the opinion that the results obtained would not be sufficiently accurate to justify its recommendation. Mr. Musselman states that he identifies the service charge and interest as one item and proposes to distribute the total in equal amounts for each period over the average life of the paper. The rather obvious fault in such a procedure is that no cognizance is taken of the fact that the uncollected balance of the paper (which is certainly at least one of the factors controlling the proper distribution) is much larger during the earlier periods of the series than during the later periods. To illustrate this point it is only necessary to mention that in the case of paper written for twelve months, the amount outstanding (i. e., the principal of the company's funds invested) is twelve times as great during the first month as in the final month, and yet the amount of income originally deferred, but subsequently taken into earnings, is the same in the first month as in the last.

Mr. Musselman states that it may be contended that the service charge had been fully earned when the note was purchased; or it may be urged with equal force that the profit is not realized until the transaction is completed. He, of course, does not recommend either of these extremes but chooses rather what appears to be an arbitrary middle course, the chief defense of which is its simplicity and conservatism.

In the last analysis a finance company makes profits by lending its money. Is it not logical, then, that the rate of return of such funds (thus made available for other enterprises) should be the controlling factor in determining when the income has been earned? The method referred to may be illustrated by reference to an instalment note written for twelve months. The multiples outstanding from the first to the final month are: 12, 11, 10, 9, 8, 7, 6, 5, 4, 3, 2, 1, aggregating 78. At the end of the first month  $12/78$  of the total service charge is taken into income;  $11/78$  at the end of the second month; etc.

Mr. Musselman justly criticizes the method of estimating the periodic profit by the application of a flat percentage of the balance in the deferred-income account, for the reason that such a basis does not fluctuate in proportion to the maturities. The

"declining investment" method described above does give effect to fluctuations in volume and changes in rates.

Finance companies frequently follow the practice of considering a portion of the service charge as earned immediately upon purchase of the paper, on the premise that expenses have been incurred in the acquisition of the paper and that, accordingly, it is proper to offset such expenses by absorbing a portion of the service charge into earnings immediately. There seems to be no real objection to this practice, provided that the proportion of service charge thus included in earnings is a reasonable one. If this procedure be followed, the brief description of the method of deferring income outlined in the preceding paragraphs should be supplemented by pointing out that the given portion of service charge, say 15 per cent., is first determined and recorded as earned income, and the balance, say 85 per cent., is then spread on the basis of 12/78, 11/78, etc.

The "declining investment" method is not generally applicable to "wholesale" paper, since this type of paper is not generally in the form of instalment-notes but is drawn in the form of time drafts, with the total amount payable at maturity. Briefly, a method may be employed for distributing the service charge on wholesale paper under which the earned element for each period is determined to be the sum of two amounts calculated by the application of flat percentages on (1) outstandings and (2) the volume of new business.

In concluding the remarks on deferring of income, mention is made that in the case of companies which have been operating long enough to develop representative experience, it has been found unnecessary to spread the income separately on each note or block of paper on the multiple basis of 12/78, 11/78, etc. Instead the total service charge may be spread on the basis of percentages developed from past experience. For practical purposes the degree of error resulting from this method is relatively small and unimportant, save when the average length of the paper changes appreciably. At such times the percentages must be appropriately revised.

#### FINANCIAL STATEMENTS AND RATIOS

Mr. Musselman's comments on the balance-sheet are commendable. However, his statement that a reserve for losses is a desirable procedure should be more positive. It is imperative

that a reserve for losses be provided if the balance-sheet is to show the true financial condition.

In closing, casual mention is made of an error in terminology in Mr. Musselman's comments on "Future cash position." The following is quoted from the article:

"The future period may include one or more accounting periods, but it should be an established period which will give its management sufficient time to make such arrangements as may be necessary to take care of the company's own obligations. The probable income will be determined from the trial balance of the subsidiary instalment-note ledger . . ."

The phrase "the probable income" should be "the probable cash receipts." Income and cash receipts are not synonymous terms.